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PRIVATE PENSIONS IN BRAZIL

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1. The Brazilian Private Pension System

The Brazilian pension system is structured in three components:

General Regime of Social Security (*Regime Geral de Previdência Social - RGPS*): It is a public, mandatory, pay-as-you-go (PAYG) scheme, managed by the National Social Insurance Institute (INSS), that covers all private sector workers up to a pensionable ceiling of approximately US$ 800. Recent reforms were oriented to strengthen the redistributive role of the basic scheme, increase coverage and correct actuarial distortions.

Pension Regime for Government Workers (*Regimes Próprios de Previdência Social - RPPS*): Civil servants are under specific pension provisions. Although the eligibility criterion is the same for all government workers, there are over 2400 specific pension regimes managed by The Federal government, States and Municipalities with specific financing rules. The regimes are mostly PAYG with some pre-funding in a few states and municipalities. The national armed forces and similar groups at state level have a career-basis scheme mostly financed by general budget. In 2003, the government promoted a comprehensive adjustment in the PAYG parameters (age limit, replacement rates, retiree's contribution) for current workers and the convergence of rules for private and public sectors that will come into force for the future generation of civil servants.

Complementary Pension Regime (*Regime de Previdência Complementar – RPC*): This scheme includes funded occupational and personal pension plans privately managed by closed and open pension funds and insurance companies. The affiliation is not mandatory and the reform efforts have been focused on the modernization of the rules and the extension of the regime's coverage.

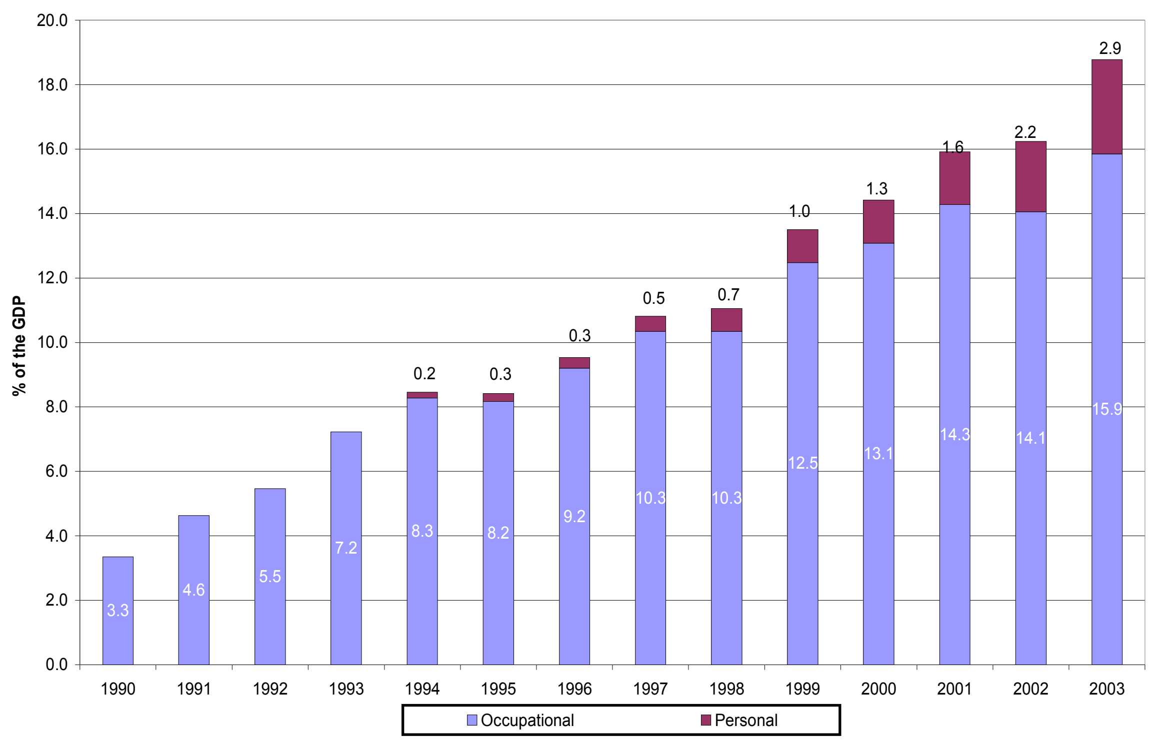
The Brazilian private pension scheme is the oldest one in Latin America. While most of the Latin American private pension industry has been developed after the Chilean pension reform in 1981, the first Brazilian regulations were issued in 1977 and there are some pension funds which are already over 80 years old. Since 2001, new regulations have been oriented to update the regulatory framework in order to promote the dynamism of the market and incorporate international standards, best practices and innovations.

In contrast with other Latin American countries, Brazil has not replaced the basic public PAYG system by a mandatory private pension scheme, but pursued reforms oriented to strengthen the redistributive role of the first pillar and to gradually develop the complementary and voluntary private pension scheme, offering an alternative for medium and high income workers to preserve their life's standard after retirement. Approximately 8% of the labor force perceive wages above the General Regime of Social Security (RGPS) ceilings and may need additional pension provisions.

1.1 Market Size and Structure

Despite the modest growth of the GDP during the 90's, Private Schemes' assets (that is, Open and Closed Entities) have increased steadily from 3.3%, in 1990, to 18.8% of GDP in 2003, corresponding to US$ 82.9 billion. In the case of closed pension funds, the high interest rate environment experienced over the last years can explain most part of the assets' accumulation. On the other hand, open pension funds' assets have increase mainly after 1994, as a result of the monetary stabilization and the attractiveness of tax-deductible products.

Graph 1: Private Pension Assets as % of the GDP in Brazil



Source: SPC/MPS (2004) and ABRAPP.

According to information consolidated by the Organization for Economic Co-operation and Development (OECD) and by the *Asociación Internacional de Organismos de Supervision* (AIOS), in 2002 Brazil reached the 7th position in the ranking of private pension assets by country and the 12th regarding the pension assets/GDP ratio (Table 1).

The Closed Private Pension Entities *(Entidades Fechadas de Previdência Complementar – EFPC)* are private, non-profit organizations, established by single employers, multiple employers and recently by labor unions or professional associations. The regime is financed by employers and/or employees contributions on occupational or associative basis. The pension funds' assets are legally segregated from the sponsors' and submitted to specific accounting, financing and actuarial regulations. Historically, the industry has grown based on the employment ties in State owned, large multinational companies following the *Bismarckian* tradition. But recently, some innovations have been implemented to extend the coverage to other groups, including small and medium enterprises, labor unions, professional associations and, in the future, civil servants. In 2003, there were 360 entities (pension funds), sponsored by 2108 companies. These pension funds (Closed Entities) have accumulated US$ 82.9 billion (15.9% of the GDP) in assets, covering 1.7 million workers (+4.2 million dependents), which is equivalent to 2.2% of the labor force, and 570 thousand beneficiaries (Table 2).

Table 1: Top 20 Largest Accumulations of Private Pensions Assets by Country - 2002

	US$ billion (a)	Ranking (a)	%of GDP (b)	Ranking (b)
United States	5,934	1	57	6
United Kingdom	1,049	2	73	4
Japan	812	3	21	11
Netherlands (*)	407	4	106	2
Canada	345	5	48	9
Switzerland	336	6	126	1
Brazil (**)	83	7	18	12
Germany	75	8	4	31
Singapore	56	9	64	5
Ireland	49	10	52	8
Denmark (*)	43	11	27	10
Chile	36	12	56	7
Spain	35	13	6	23
Mexico	31	14	5	25
Hong Kong	28	15	17	13
Italy	24	16	2	35
Portugal	16	17	13	16
Belgium	14	18	6	24
Argentina	12	19	11	17
Korea	12	20	3	33

Source: OECD and AIOS

(*) 2001

(**) 2003

The Open Private Pension Entities (*Entidades Abertas de Previdência Complementar – EAPC)* – that manage the plans – may be operated by insurance companies, bank's subsidiaries and non-profitable organizations and offer pension plans to employees, employers, self employed and non-employed. The plan can be contracted out by enterprises as fringe benefit to their employees or, more commonly, contracted directly by individuals. This pension scheme is somewhat inspired by the North American 401k experience. Currently, there are 43 providers and asset accumulation was US$ 15.2 billion (2.9% of the GDP) in 2003, with 2085 plans in operation (Table 2).

Brazilian employers have several options regarding private pension provision at their disposal: (i) establish and sponsor an occupational pension fund; (ii) participate in an already existing multi-sponsored pension fund; iii) make eventual contributions to associative pension funds and (iv) contract out a group or personal pension plan. At the same time, individuals can both participate in the plan (or plans) offered by his/her employer and/or contract by him/herself a personal pension plan. The diversity and complexity of the market contribute to increase competitiveness, diminish costs and reduce systemic and individual risks. Nonetheless, in order to achieve these results, it is necessary to develop the consumers' financial literacy and improve the regulatory adequacy between both sectors (occupational and personal).

Table 2: Private Pensions in Brazil – Main Indicators – Dec/2003

	Occupational	Personal	Total
1.Number of Funds/Institutions	360	43	403
2.Number of Plans	949	2085	3034
Defined benefit	345	751	1096
Defined contribution	154	1285	1339
Mixed	450	49	499
3.Participants (million)	6.5	(-)	NA
Contributors	1.7	7.3(*)	NA
Dependents	4.2	-	NA
Contributors/Labor Force	2.3	NA	NA
Participants/Population	3.7	NA	NA
4.Assets (US$ billion)	82.9	15.2	97.4
Assets/GDP	15.9	2.9	18.8

Source: SPC/MPS and SUSEP/MF.

(*) In the personal pension plans the available information refers to the number of contracts and the same individual can have more than one contract. There is also double county in the membership between occupational and personal plans, therefore the total is not reported.

NA – not applicable

(-) not available

The closed pension funds are supervised by The State Secretariat of Pension Funds *(Secretaria de Previdência Complementar – SPC*), a public body formally linked to the Ministry of Social Security, that licenses pension entities and supervises their compliance with governance, disclosure, rights of beneficiaries, investment, benefit provision, fees and other regulations. The main regulatory decisions are made by the National Board of Complementary Pensions *(Conselho de Gestão da Previdência Complementar – CGPC),* linked to the Ministry of Social Security and composed by 5 members representing the government (including the chair) and 3 representatives of employers, participants and pension funds, respectively.

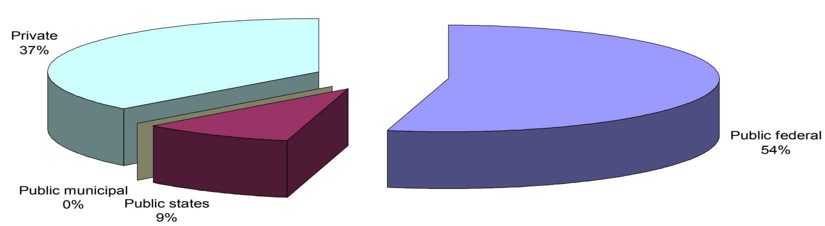
The supervision of open pension funds is under the competence of the Superintendence of Private Insurance *(Superintência de Seguros Privados – SUSEP),* linked to the Ministry of Finance. The National Board of Private Insurance *(Conselho Nacional de Seguros Privados - CNSP)*, also attached to the Ministry of Finance, is in charge of the regulations.

Generally, the contributions to all private pension plans are tax-deductible up to 12% of the employee's salary for workers and 20% of the wage bill for employers. Based on an important decision made by President Lula, beginning in January 2005 the investment returns will no longer be taxed. This change intends to encourage the development of Pension Funds on a long-term basis.

Closed pension funds offer defined benefit plans, defined contribution plans or mixed arrangements, except funds sponsored by labor unions, professional associations and the pension funds for civil servants, all of which that can only manage defined contribution plans. According to Brazilian regulations, the mixed arrangements are defined contribution plans with some ingredients of defined benefit provision like the *cash balance plans*, *floor benefit plans* and *target benefit plans*. In occupational schemes, the accumulated funds in individual accounts are portable under certain restrictions, as a vesting period of 3 years at most, and withdrawals are conditioned to the act of retirement or the termination of employment.

The most part of the occupational pension funds assets (63%) are held by entities sponsored by state owned companies (Graph 2). Although the new plans being created are defined contribution, most participants and assets are still in defined benefit plans.

Graph 2: Total Pension Funds Assets by Type of Sponsor in Brazil – December/2003



Source: SPC/MPS (2004).

The top 3 largest pension funds, accounting for more than 40% of the assets, are sponsored by federal, state owned companies (Table 3). However, the number of mixed arrangements and defined contribution plans are increasing. The latest data available (2003) shows that there are 345 DB, 154 DC and 450 mixed plans.

In order to mitigate the risks of DB public sponsored pension plans and avoid future transfers of liabilities to tax payers, recent regulations established that the maximum contribution from the sponsor should match the employer's contribution and eventual actuarial unbalances should also be solved respecting the parity between employee and employer's contributions.

Table 3: Top 10 Brazilian Closed Pension Funds in Assets – March 2004

Pension Fund	Sponsor	Assets
	Public	19.9
	Public	7.9
	Public	5.4
	Private	4.5
	Private	3.8
	Public	2.0
	Private	1.8
	Private	1.8
	Public	1.8
	Public	1.5
		50.4
		82.7

Source: SPC/MPS.

1.2. Extending the Coverage

16. The occupational pension funds coverage is still relatively low – 2.2% of the labor force – and theoretically it could be extended to 8% of workers that earn salaries above the General Regime of Social Security ceiling. Historically, occupational pension fund provision has been restricted to well-organized groups of employees of state owned, large multinational companies with sufficient scale and financial capacity to respond to the political labor unions' demands. Additionally, until the latest pension reform in 2003, civil servants used to retire with 100% of the final salary and were not able (or did not need) to join occupational schemes. It is important to point out, however, that this issue is still under debate by regulators and, so far, civil servants have not been allowed to join such schemes.

17. Since 2001, several policies have been designed and implemented to increase coverage, such as the regulation of the multi-sponsored pension funds. This new possibility is addressed mainly to small and medium enterprises without enough scale to establish a pension fund for their employees. Instead of creating a new institution, these firms can contribute to an already existing pension fund or to an institution specialized in pension fund administration that can manage plans sponsored by several companies. The multi-sponsored pension funds have been constituted to optimize the industry's structure, increase economies of scale, reduce entry barriers, and thus increase coverage.

18. In 2003, new regulations have been issued by the National Board of Complementary Pensions regarding the possibility of professional associations, labor unions, confederations and other associative institutions to establish pension funds. Associated workers (or non-employed) can opt to contribute to the plan established by the association. The employer, if it is the case, can also participate in the financing according to the employment agreement. Nonetheless, the employer is not co-responsible and the amount and regularity of the employer's contributions can be negotiated, changed and interrupted at any time. The plan must be defined contribution and asset management must be outsourced. Insurance companies may insure non-programmed risks whereas financial institutions may not.

19. This innovation aimed to adapt the pension regulation to the dynamism of the Brazilian labor market. Traditionally, the occupational pension scheme has been organized vertically to the economic structure, pending on the employer's initiative. Large enterprises have used occupational schemes as a key human resources tool to attract good professionals and provide incentives for long-term careers. However, the labor market structure has been changed, especially in the services area. Recent trends have shown an increase in the contractual flexibility, high job turnover and variable earnings that could be incompatible with the rigid vesting and financing conditions of the traditional occupational schemes. Associative pension funds are organized by Labor Unions, covering groups of workers from different companies independently from the employment link or status. The combination between contractual conditions, flexibility, and defined contribution plans and outsourced asset management may be an efficient option to workers submitted to unstable labor conditions. Until May 2004, 14 associative pension funds have been created, covering potentially 1.2 million participants.

20. Besides these initiatives, the 2003 pension reform changed the civil servants pension scheme, reducing replacement rates, increasing contributions, tithing eligibility criteria and introducing the General Regime of Social Security cap (US$ 800) to the contributions and benefits of the new entrants after the establishment of the pension funds. According to the new legal provisions, future civil servants will have the possibility to supplement their benefits through the affiliation to Complementary Occupational Pension Funds. Such funds can only offer defined contribution plans. Their implementation is not mandatory and depends on laws proposed by federal, states and municipal governments to create their own pension funds. The employer's contributions should be, at most, equal to the worker's contributions, and the rules applied should be the ones in effect in the current complementary pension regime. According to official estimations, 1/3 of the future Federal Government workforce will earn above the General Regime of Social Security ceiling and might be willing to join the new complementary pension scheme. Civil servants' salaries are lower at sub national levels, but there are some large States and Municipalities that may introduce complementary pension funds.

21. Considering the impact of these legal innovations, government officials are expecting to duplicate the number of participants and beneficiaries in occupational pension plans by 2010, when it would reach 5 million people.

1.3 Governance and Investment Regulations

22. The minimum organisational structure of Brazilian pension funds shall comprise the Governing Board (*Conselho Deliberativo*), the Supervising Board (*Conselho Fiscal*) and the Executive Directorate (*Diretoria-Executiva*).

23. The Governing Board is ultimately responsible for the pension fund management. In the funds sponsored by the public sector (state-owned companies or public administration), the

Governing Board shall be composed by a maximum of 6 members - 3 nominated by the sponsor and 3 elected by participants and beneficiaries. The president of the board shall be appointed by the sponsor and shall hold the responsibility for the final decisions in case of absence of a majority agreement. The board member's mandate is 4 years long and the appointment can be renewed for one more term. During the mandate, board members might leave their duties only in case of renouncement, judicial condemnation or disciplinary administrative process.

24. The Governing Board is responsible for:

i. Designing the general pension fund and plans management policy;

i. Approving changes in the pension plan statutory provisions;

ii. Closing the pension fund or pension plans;

iii. Authorising the sponsor to leave the pension fund;

iv. Approving investment strategies and asset allocation;

v. Authorising investments amounting for more than 5 per cent of the assets;

vi. Contracting out independent actuarial evaluations and auditors;

vii. Nominating and dismissing members of the Executive Directorate;

viii. Reviewing decisions of the Executive Directorate.

25. The Supervising Board shall be responsible for the pension fund internal controls. A maximum of 4 members, 2 representing the sponsor and 2 representing participants and beneficiaries compose this body. Participants and beneficiaries appoint the president. The mandate is 4 years and is non-renewable.

26. The Executive Directorate, composed by maximum of 6 members, is responsible for the daily management of the entity according to the guidelines approved by the Governing Board. The details regarding the division of responsibilities and representation shall be established in each pension fund's statutory provisions.

27. In the public-sponsored pension funds, the members of the Executive Directorate shall not work for the sponsor; participate neither in the Governing nor Supervising Boards after finishing his/her term and before the approval of the pension funds accounts, also they may not work for any financial institution during the mandate. In the following 12 months after finishing the term, the former member of the Executive Directorate shall not work for any financial institution that could take advantage of the inside information disclosure.

28. Generally, the members of the Executive Directorate shall present at least an undergraduate degree and working experience in one of the following areas: financing, management, accounting, auditing, legal or actuarial. Moreover, the absence of criminal antecedents or administrative penalties is required.

29. <u>In pension funds sponsored by private companies</u>, the governance regulations are more flexible. They are also required to have a Governing Board, a Supervising Board and an Executive Directorate, but the statutory provisions shall define the criteria for participation of members in the

boards as well as the division of responsibilities. Nonetheless, participants shall hold a minimum of 1/3 of the boards' representation.

30. The pension funds' investment regulations are issued by the National Monetary Council (*Conselho Monetário Nacional* – CMN). Currently, pension funds' asset allocation is submitted to maximum quantitative limits across and within asset classes taking into account financial instruments, credit risk and governance criteria.

31. The Brazilian pension fund governing board must nominate a manager technically and legally responsible for the asset allocation in compliance with the regulations as well as for providing any information required. This manager must submit, annually, the investment policy strategy prepared in accordance with the asset liability approach and risk assessment evaluations to the State Secretariat for Pension Funds. Investment regulations also require pension funds to implement risk management control tools for each plan. The adoption of the "tracking error" methodology is mandatory. After checking and approving the adequacy of the investment policy to the regulations and the overall actuarial, financial and risk assessment consistency, Pension Funds have to forward the document to the State Secretariat for Pension Funds. In this process, independent auditor, actuarial and custodian services are required.

32. According to the Regulation of The National Monetary Council, issued in September 2003, Occupational Pension Funds have no limits to allocate resources in Federal Government bonds. Nonetheless, the aggregated investment in low credit risk bonds issued by states and municipalities, financial and non-financial institutions and in savings accounts and low credit risk mutual funds shares is limited to 80% of the total assets allocation. In case these financial instruments are classified as medium or high-level credit risk, the maximum limit for asset allocation would decrease to 20%.

33. The investment in listed stocks is limited to 50% of the portfolio for companies with good corporate governance rating; 45% for companies with regular governance rating and 35% for non-classified companies. The limit for private equity investment is 20%. The Brazilian Stocks Exchange – BOVESPA calculates the corporate governance rating and the International Securities Identification Number (ISIN) must identify all securities in the pension fund portfolio. Foreign investment is limited to 3% and restricted to Brazilian Depositary Receipts (BDRs) and stocks listed in the MERCOSUR's capital markets.

34. Beside these restrictions, there are some concentration clauses. Pension funds can hold a maximum 20% of the capital of a single company and at most 5% of the pension fund capital can be allocated to a single company.

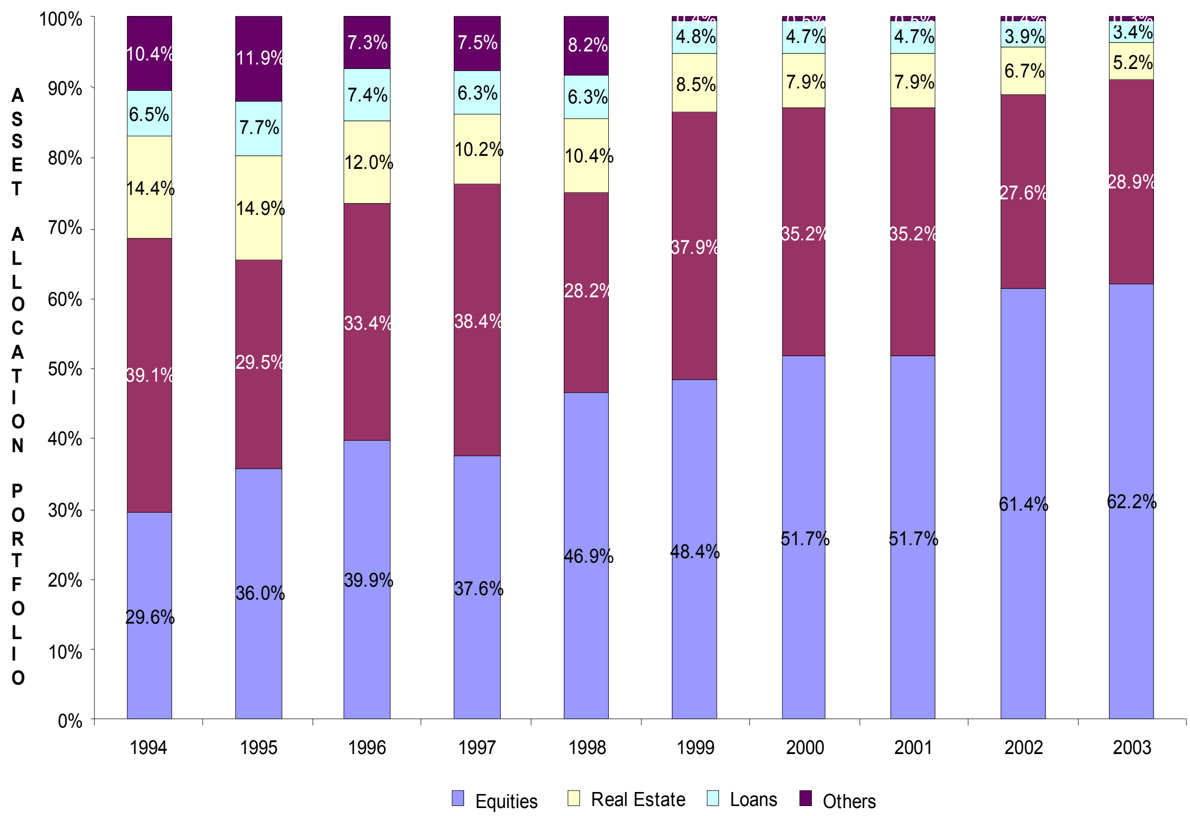
35. Nowadays real state investments are limited to 14% and this limit is gradually decreasing to 8% until 2009. Loans to participants are restricted to 15% of the total assets and interest rates cannot be lower than the investment target (used in the actuarial evaluation) plus administrative costs.

36. In recent years, pension funds have allocated their investments mostly in bonds. By 2003, almost 2/3 of the pension investments were directed to Federal Government bonds. It might be explained by the high interest rates offered in the last decade and the absence of long-term investment alternatives in the Brazilian capital market.

37. However, as macro stability is taking hold and real interest rates decline, some of these resources allocated in government bonds might migrate to more attractive financial alternatives as corporate bonds, listed equities, private equity and even infrastructure projects. The inter action

between pension funds and capital markets may benefit both sides. The increasing demand for shares may pursue the development of the market capitalization and volume traded, increasing liquidity, improving regulations and transparency and fostering financial innovation, competition and efficiency.

Graph 4: Closed Pension Funds Asset Allocation in Brazil 1994-2003



Source: SPC/MPS